UNC SCHOOL OF LAW

NORTH CAROLINA BANKING INSTITUTE

Volume 10 | Issue 1

Article 16

2006

Equity Investment in Chinese Banks: A Doorway into China's Banking Sector

Jack E. Jirak

Recommended Citation

Jack E. Jirak, *Equity Investment in Chinese Banks: A Doorway into China's Banking Sector*, 10 N.C. Banking Inst. 329 (2006).
Available at: http://scholarship.law.unc.edu/ncbi/vol10/iss1/16

Equity Investment in Chinese Banks: A Doorway into China's Banking Sector

I. INTRODUCTION

China's banking sector is slated to open completely to foreign access in 2006 in accordance with China's World Trade Organization ("WTO") accession agreement.[1] The opportunity for entry into a 1.3 billion-person[2] market, with over $1.8 trillion in personal savings,[3] has left many banks salivating. Yet while the enormous opportunity is clear, the exact path is not.[4] This Note will examine potential barriers and obstacles to foreign investment in China's banking sector and will analyze the benefits of acquiring equity shares in domestic banks.[5]

Part II of this Note provides some basic background concerning the evolving Chinese economy and China's banking sector.[6] Part III examines the major factors that foreign investors must weigh as they consider how best to gain entry to the Chinese banking market.[7] Finally, Part IV demonstrates that equity acquisition has been the primary path of entry into the Chinese banking market and analyzes how this approach effectively deals with some of the concerns and challenges described in Part III.[8]

---

1. Richard McGregor, *Foreign Banks Count the Days to China's WTO Link*, FIN. TIMES (London), May 18, 2001, at 23.

2. CENTRAL INTELLIGENCE AGENCY, THE WORLD FACTBOOK 114 (Central Intelligence Agency 2004), *available at* http://www.cia.gov/cia/publications/factbook/geos/ch.html.

3. *See* Brian Bremner, *Betting on China's Banks: The Biggest IPO on Earth May Signal the Start of a Rich, New Era in Financial Markets*, BUS. WK., Oct. 31, 2005 ("The Buy China syndrome has long gripped global investors entranced by the country's hypergrowth story.").

4. *See generally* Carol G. Liu, *New and Foreign Banking Markets: Scaling the Great Wall: An Analysis of Foreign Banks' Entry into China*, 9 N.C. BANKING INST. 397 (2005) (arguing that foreign banks can choose to enter the market through equity acquisition or establishment of foreign bank branches).

5. *See infra* notes 6-202 and accompanying text.

6. *See infra* notes 9-38 and accompanying text.

7. *See infra* notes 39-131 and accompanying text.

8. *See infra* notes 132-95 and accompanying text.

II. EVOLVING ECONOMY

A. Recent History

In the past twenty-seven years, China has journeyed down a radical path of modernization and privatization.[9] As a part of this transition, the Chinese banking sector has undergone dramatic changes.[10] Deng Xiaoping, the de facto leader of the country, declared in 1978 that China's banks would begin to operate like "real banks."[11] Prior to this time, China's banking sector was essentially a "monobank financial system" whose sole aim was to further the political and social agenda of the socialist government.[12] However, subsequently, the Chinese government embarked on an ambitious program of privatization and reform within the banking sector designed to facilitate and promote continued growth of the economy.[13]

In 1986, China's government issued a significant set of new banking regulations aimed at achieving these objectives.[14] Commercial lending was separated from the People's Bank of China ("PBC") and given to four specialized banks (the "Big Four"):[15] the Agricultural Bank of China, the Bank of China, China Construction Bank, and the Industrial and Commercial Bank of China.[16] Prior to the current wave of investment activity, the Big Four were wholly-owned by the government.[17] In 1994, the government formed three policy banks in

9. Lan Cao, *Public Perspectives on Privatization: Chinese Privatization: Between Plan and Market*, 63 LAW & CONTEMP. PROB. 13, 13 (2000).

10. Amy Chunyan Wu, *PRC's Commercial Banking System: Is Universal Banking a Better Model?*, 37 COLUM. J. TRANSNAT'L L. 623, 623 (1999); *see generally* Andrew Xuefeng Qian, *Transforming China's Traditional Banking Systems Under the New National Banking Laws*, 25 GA. J. INT'L & COMP. L. 479 (1996) (examining impact of new banking laws on China's banking sector).

11. Chuyan, *supra* note 10, at 623.

12. Alicia Garcia Herrero & Daniel Santabarbara, Where is the Chinese Banking System Going with the Ongoing Reform? 12 (2004), http://www.bde.es/informes/be/ocasional/do0406e.pdf).

13. *See* Qian, *supra* note 10, 480-86.

14. *Id.* at 482.

15. *Id.*

16. Wei J. Lee, *China and the WTO: Moving Toward Liberalization in China's Banking Sector*, 1 DEPAUL BUS. & COMM. L.J. 481, 493 (2003).

17. Sayuri Shirai, *Banking Sector Reforms in the People's Republic of China—Progress and Constraints*, *in* REJUVENATING BANK FINANCE FOR DEVELOPMENT IN ASIA AND THE PACIFIC, 49, 50 (2002), *available at* http://www.unescap.org/drpad/publication/toc/fin%5F2206con.htm.

order to further free the Big Four from making policy loans, which had inhibited their attempts to become fully commercial.[18]

While estimates vary, the Big Four currently account for between fifty percent to sixty percent of the total assets of the Chinese banking system.[19] The remaining banking assets are controlled by the three policy banks, city and nationwide commercial banks, and urban and rural credit cooperatives.[20] And though China has gradually eased restrictions on the ability of foreign banks to operate in the country, as of September 2003, foreign banks held only 1.2% of total banking assets.[21]

China's two major regulatory institutions are the PBC and the China Banking and Regulatory Commission ("CBRC"), which are both ultimately accountable to the State Council, China's governing body.[22] The PBC's major responsibilities include setting and overseeing monetary policy and managing and maintaining payment systems.[23] Established in April 2003, the CRBC plays a supervisory role, overseeing and regulating banks and other financial institutions.[24]

B. Further Opening of the Financial Sector

China's plan for financial modernization continued as China sought admittance to the WTO in the late 1990s.[25] As part of its accession to the WTO in 2001, China agreed to completely open its markets to foreign competition.[26] A five-year plan is in place, at the end

18. Qian, *supra* note 10, at 484; *see also* Lawrence L. Lee, *Integration of International Financial Regulatory Standards for the Chinese Economic Area: The Challenge for China, Hong Kong, and Taiwan*, 20 NW. J. INT'L L. & BUS. 1, 13 (1999) ("These 'policy' banks include: the Import-Export Bank, which helps finance major trade deals, the State Development Bank, which funds infrastructural projects, and the Agricultural Development Bank of China, which funds agricultural procurement for rural development.").

19. Herrero & Santabarbara, *supra* note 12, at 16.

20. Shirai, *supra* note 17.

21. Herrero & Santabarbara, *supra* note 12, at 15.

22. Liu, *supra* note 4, at 398.

23. *Id.* at 399-400.

24. *Id.*

25. *See generally* Raj Bhala, *Enter the Dragon: An Essay on China's WTO Accession Saga*, 15 AM. U. INT'L L. REV. 1469 (2000) (detailing the specifics of China's WTO accession).

26. Lee, *supra* note 16, at 481; *see also* SUMMARY of US-CHINA BILATERAL WTO AGREEMENT, Feb. 2, 2000, http://www.ogc.doc.gov/ogc/legreg/testimon/106s/daley0411 attachment.htm.

of which, China is to completely open the banking sector,[27] including the "eliminat[ion of] all 'non-prudential' restrictions on the banking sector, including ownership and operation restrictions."[28] This includes the removal of all geographic and customer restrictions currently in place; by the end of 2006, foreign banks are, in theory, to be treated in the exact same manner as Chinese banks.[29]

C. An Enormous Growth Opportunity for Foreign Investors

The percentage of American banks' profits derived from foreign activities has increased in recent years.[30] Citigroup and JP Morgan Chase, the two largest U.S. banks, earned half of their net income from overseas operations.[31] But while overseas activity continues to grow, the amount of income derived from banking activity in China remains small.[32] For instance, of the $7.65 billion of revenue reported by Citigroup in Asia in 2004, only two percent was attributable to China.[33]

Given the enormous size of the Chinese market[34] and its potential for investment opportunity,[35] commentators have speculated that banks will rush to tap into this emerging market.[36] However, the

---

27. Liu, *supra* note 4, at 397.

28. Karen Halverson, *China's WTO Accession: Economic, Legal, and Political Implications*, 27 B.C. INT'L & COMP. L. REV. 319, 338 (2004).

29. Liu Mingkang, Chairman of China Banking Reg. Comm'n, Speech at International Investment Forum of 2004 CFIIT: Creating a Favorable Environment for the Further Opening of China's Banking Industry (Sept. 8, 2004) (on file with North Carolina Banking Institute).

30. Frederick W. Stakelbeck, Jr., *U.S. Banks Investing in China*, IN THE NAT'L INTEREST, Sept. 21, 2005, http://www.inthenationalinterest.com/Articles/September%202005/September2005Stakelbeck.html.

31. *Id.*

32. *See* Gautam Chakravorthy & Subramaniam Sharma, *Citigroup's Prince Sees 50% of Business Outside U.S.*, BLOOMBERG.COM, Oct. 14, 2005, http://www.bloomberg.com/apps/news?pid=10000080&sid=ahaPVmMJvVOU&refer=asia.

33. *Id.*

34. *Bank of America Buys Stake in China Bank: Move is Largest Investment in by Foreign Financial Firm*, MSNBC, June 17, 2005, http://www.msnbc.msn.com/id/8253765/ ("'This investment is aimed at creating a long-term benefit by partnering with the best positioned bank in China, which is one of the fastest growing economies in the world with 1.3 billion consumers,' Kenneth D. Lewis, [B OF A] chairman and chief executive officer, said in a statement.").

35. RBS Leads $3.1bn China Investment, BBC NEWS, Aug. 18, 2005, http://news.bbc.co.uk/2/hi/business/4162170.stm ("The [Chinese] market . . . is estimated to hold $1.5 trillion in personal savings"); *see also* Stakelbeck, *supra* note 30.

36. Stakelbeck, *supra* note 30 ("With an astounding one billion bank customers, a

optimal route of entry is not clear.[37] Banks can either work towards establishing independently operating branches in anticipation of the full relaxation of restrictions in 2006 or can choose to pursue a portion of the Chinese banking market through acquisition of equity in existing Chinese banks.[38]

III. MAJOR FACTORS TO CONSIDER FOR FOREIGN BANKS

As foreign banks consider how best to gain access to this emerging market, they must weigh a wide variety of factors which include the following.[39]

A. Post-2006 Regulatory Burdens

While in principle, the Chinese government has promised to ease all restrictions by the end of 2006, the reality is that foreign bank branches will still be forced to deal with a host of additional regulatory requirements.[40] Though specific geographic restrictions will be eased, foreign banks seeking to establish branches must contend with "onerous representative office seasoning requirements; branch-level capital reserve, liquidity, and deposit requirements; foreign exchange deposit/foreign exchange asset ratio limitations; and lengthy branch application procedures."[41]

Furthermore, China currently limits the total equity owned by foreign investors in any one bank to twenty-five percent overall and

---

burgeoning middle class, cumulative household savings of $1.65 trillion and annual GDP growth of 9 percent, China is an attractive investment alternative for banks located throughout the world.").

37. Liu, *supra* note 4, at 397.

38. *Id.*

39. *See infra* notes 40-131 and accompanying text.

40. Nicholas C. Howson & Lester Ross, *Foreign Minority Equity Investment in Chinese Commercial Banks*, CHINESE BUS. REV., July-Aug. 2003, *available at* http://www.chinabusinessreview.com/public/0307/howson.html

> Although foreign banks will be allowed to do renminbi business with Chinese individuals from the end of next year, lifting the last big restriction on their activities in China, it is almost certain that the obstacles towards any of them establishing a major branch network will remain in place, particularly the high capital requirement for opening a branch.

Id.

41. *Id.*

twenty percent for a single foreign investor.[42] Various officials have occasionally hinted that the cap may be raised[43] but, in recent comments, China's central bank governor Zhou Xiaochuan made clear there are no current plans in place to raise the limits.[44] Zhou went even further in asserting that China has no obligation under the WTO agreement to raise this particular limit at all.[45]

B. Underdeveloped Administrative and Judicial Structures

Banking is generally a highly regulated sector and a sophisticated banking market like that of the United States has developed hand in hand with regulatory systems commensurate to the task.[46] China's administrative and regulatory framework for banking as well as its judicial system, only now in their infancy, are faced with the challenge of attempting to deal with an aspiring 21st century banking system.[47]

When considering the ability of China's administrative and judicial framework to handle a highly sophisticated banking market, one must keep in mind that as recently as 1978, China had no "meaningful legal institutions,"[48] and that China's first banking regulatory agencies were formed in 1995, just ten years ago.[49] In accordance with its accession to the WTO, China agreed to "apply and administer all WTO-related laws, regulations, and other measures in a 'uniform, impartial and reasonable manner.'"[50] Commentators speculate that such a goal

---

42. Cap on Foreign Investment in Chinese Banks Remains in Place, BBC MONITORING INT'L REPORTS, Nov. 3, 2005.

43. Michele Batchelor & Karen Gullo, *China May Ease Limits on Foreign Banks*, CHINA DAILY, Sept. 14, 2005, http://www.chinadaily.com.cn/english/doc/2005-09/14/content_477695.htm.

44. *Cap on Foreign Investment*, *supra* note 42.

45. *Id.*

46. *See generally* LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK AND FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS, 1-79 (2nd ed. 2004) (explaining the history of the American banking system).

47. *See generally* Randall Peerenboom, *Globalization, Path Dependency and the Limits of Law: Administrative Reform and Rule of Law in the People's Republic of China*, 19 BERKELEY J. INT'L L. 161 (2001) (examining China's developing administrative and legal institutions and concluding that, while progress has been made, many more changes are needed).

48. Halverson, *supra* note 28, at 354.

49. *See* Qian, *supra* note 10, at 480-86.

50. Halverson, *supra* note 28, at 352.

may, at least in the immediate future, be out of the reach of a fledgling administrative and judicial system that does not have much experience drafting clear and detailed regulations and lacks a track record or tradition of administering law in an impartial and unbiased manner.[51]

Furthermore, the difficulties that face the Chinese regulatory system are not only organizational and technical but cultural as well.[52] As Randal Peerenboom points out, "China is a single party socialist state saddled with a transition economy, an immature legal system, and a historical legacy of more than two millennia in which the subordinate role of law as a means of achieving social order stunted the growth of a culture of legality."[53] While the cultural barriers are often more difficult to quantify and measure, they can also often be the most intransigent.[54]

This is not to say that no progress has been made.[55] China has made efforts to increase legal education and awareness.[56] The government recently embarked on its third five-year plan to educate the public about laws.[57] The government has broadcast live trials on television and sponsored radio shows in order to educate citizens about their legal rights.[58] But continuing uncertainty in the judicial and administrative framework presents serious questions about China's ability to handle a banking system vaulting into the 21st century.[59]

C. Governmental Boundaries, Transparency, and Clarity

Other related problems flow from the immaturity of China's developing administrative and judicial system.[60] Even if China is able to put adequate regulatory structures and systems in place, some have speculated that Chinese administrative agencies, accustomed to possessing broad discretion in their decision-making powers, will be

---

51. *Id.* at 352-53.
52. *See* Peerenboom, *supra* note 47, at 261.
53. *Id.*
54. *Id.*
55. *See infra* notes 56-57 and accompanying text.
56. *See* Peerenboom, *supra* note 47, at 191.
57. *Id.*
58. *Id.*
59. *Id.*
60. *See infra* notes 61-67 and accompanying text.

resistant to concrete restraints placed on their authority.[61] Government agencies tend to resist any efforts directed towards decreasing the extent of their control and oversight.[62] And the "lack of transparency, public supervision, and right of access to information" will only make the government agencies more prone to corruption.[63] Furthermore, reliance on the public and the media to serve as a curtailing influence on government power is not a viable option in China, given the lack of access to information and the tight control exerted by the government over the media.[64]

Examples of inadequate or inequitable administrative procedures abound.[65] The Office of the United States Trade Representative reports that in 2002, Chinese ministries and agencies failed to provide adequate opportunity for public comment on new and modified regulations despite a 2001 mandate from the State Council to improve such procedures.[66] Such procedural shortcomings necessarily "undercut the predictability and openness of the Chinese business climate."[67]

D. Non-Performing Loans

The staggering amount of non-performing loans ("NPLs") which remain on the books of Chinese banks also concerns investors.[68] The existence of NPLs is a legacy of the role that China's banking system played prior to the current reforms.[69] At that time, banks served primarily as a funding source for programs dictated by state-owned enterprises.[70]

---

61. Peerenboom, *supra* note 47, at 179.

62. *Id.* at 185.

63. *Id.* ("The absence of democratic traditions may explain in part why China has been slow to pass a procedural law that would provide effective channels for public participation in these processes.").

64. *Id.*

65. *See* Peter K. Yu ET AL., *China and The WTO: Progress, Perils, and Prospects*, 17 COLUM. J. ASIAN L. 1, 21 (2003).

66. *Id.*

67. *Id.*

68. Louise do Rosario, *Bad Debt Mountain a Persistent Obstacle*, BANKER, Jan. 1, 2003, at 73.

69. Hui Cao, *Asset Securitization: Is it a Resolution Option For China's Non-Performing Loans?*, 28 BROOKLYN J. INT'L L. 565, 571 (2003).

70. *Id.*

While precise numbers are unclear, the current overall picture is not positive.[71] Scholars have speculated the NPLs comprised anywhere from ten percent to forty percent of all banking assets.[72] Dai Xianglong, the governor of the PBC "officially recognized that the ratio of NPLs to total outstanding loans at the [B]ig [F]our was 25%" in 1999.[73] In 2001, Standard and Poor's ("S&P") predicted that the Big Four would require $540 billion, half of China's annual GDP, to account for NPLs.[74]

Official figures from the Chinese government indicate that the amount of NPLs "fell to 13.2% at the end of 2004, compared with eighteen per cent the year before."[75] However, some western analysts disagree with such assessments and put the amount of NPLs in the banking system at around forty percent.[76] In May 2005, S&P put the figure at around thirty-one percent.[77] Others suggest "the staggering figure of NPLs has already made the [B]ig [F]our technically insolvent."[78] Furthermore, some commentators assert that the abuse of the state-owned banking system continues today, with government

---

71. *See infra* notes 72-81 and accompanying text.

72. Cao, *supra* note 69.

73. *Id.*

74. *Id; see also* Robyn Meredith, *China Fever: Mainland Stocks are Hot, but Many Are Just Sick*, FORBES, July 4, 2005, at 83 ("Some of the biggest China IPOs due this year are in the shaky sector of banking. Academics and economists outside China say 25% of all Chinese bank loans are bad. A bailout would cost China a punishing 17% of its gross domestic product, or $280 billion, UBS says.").

75. C.P. Chandrasekhar, *Chinese Banking: The New Frontier for Global Finance*, MACROSCAN, Sept. 30, 2005, http://www.macroscan.com/cur/sep05/cur300905Chinese_Banking.htm.

76. *HSBC to Pay $1.75b in Landmark China Bank Deal*, DAILY TIMES, Aug. 8, 2004, http://www.dailytimes.com.pk/default.asp?page=story_8-8-2004_pg5_22; *see also Billion-Dollar Gamble; Foreign Investment in China's Banks*, ECONOMIST, Sept. 3, 2005 ("To spruce themselves up for listing, the banks have been selling off their old non-performing loans: they even put their bad-loan ratios in single digits, although the true figures are probably still much higher.").

77. Brian Bremner & Dexter Roberts, *Wanted: A Big Broom For China's Banks: Beijing is trying to sweep away corruption and bad loans at its huge state lenders before taking them public*, BUS. WK. ONLINE, May 9, 2005, http://www.businessweek.com/magazine/content/05_19/b3932074.htm.

78. Cao, *supra* note 69, at 572; *see also* Craig Phillips, *Banks Have a Long Way to Go to Win Confidence*, THE AGE, Oct. 21, 2005, http://www.theage.com.au/news/business/banks-have-a-long-way-to-go-to-win-confidence/2005/10/20/1129775901483.html ("Meanwhile it was recently touted that to fix China's bad loans fiasco in the country's state-owned commercial banks alone, the Chinese Government would have to fork out the equivalent of 44 per cent of the nation's gross national product (GNP). This, according to the latest figures released by the World Bank, equates to approximately $1 trillion.").

officials using the banks as piggy banks for government projects.[79] Though the Chinese government has sought to make banks assume full responsibility for profits and losses, progress has been slow.[80] Great pressure still exists to make loans to state-owned enterprises or recently privatized state-owned enterprises that are still controlled by party leaders.[81]

Steps have been taken to address the problem.[82] In 1998, the Chinese government "bailed out [the Big Four] with capital infusion of $33 billion"[83] and in 2004 gave over $45 billion to the Bank of China and China Construction Bank, in an effort to rid the banks of bad loans.[84] In 1999, China also removed over $169 billion worth of NPLs from the Big Four and sent them to asset management companies.[85] China hopes that these efforts will stabilize the banks and allow them to

---

79. Yu et al., *supra* note 65, at 6-7.

80. Nicholas R. Lardy, *When Will China's Financial System Meet China's Needs?* (Ctr. for Res. on Econ. Dev. and Pol'y Reform, Working Paper No. 54, 2000), *available at* http://scid.stanford.edu/pdf/credpr55.pdf.

81. Bremner & Roberts, *supra* note 77; *see also* Cao, *supra* note 9 at 38-40.

> Despite financial-sector reforms in which the government replaced direct subsidies to state enterprises with bank loans—again, in an effort to create some semblance of hard budget constraints on the relevant economic actors—capital, in the form of bank credit, continues to be lavished upon state enterprises at the request of the managers, regardless of whether the loans will be repaid . . . . State-owned commercial banks, which are theoretically self-supporting but in reality supported by the state, continue to provide credit to state firms on non-market terms, performing none of the functions associated with commercial lending, neither screening the borrowers for creditworthiness nor monitoring and enforcing the loans. In fact, banks are often directed by the central government to make non-commercial, policy-based loans to certain state firms, in which case the loans may be supported by the credit of the central bank itself, the [PBC], based on lending quotas allocated by the PBC to regional banks nationwide. Banks may also be pressured by provincial and local government agencies into making loans to politically favored state enterprises, a problem that has grown even worse because of decentralization.

Id.

82. *See infra* notes 84-88 and accompanying text; *see also* Phillips, *supra* note 78 ("It cannot be stressed too much that financial markets are essentially information-processing systems and the lack of information and data seriously impairs their operation.").

83. Michael Backman, *Lining Up to Join China Bank Crisis*, THE AGE, Oct. 5, 2005, http://www.theage.com.au/news/business/lining-up-to-join-china-bank-crisis/2005/10/04/1128191714880.html?oneclick=true.

84. Li Yong Yan, *China's $45 Billion Bank Headache*, ASIA TIMES ONLINE, Jan. 9, 2004, http://www.atimes.com/atimes/China/FA09Ad02.html.

85. Cao, *supra* note 69, at 565.

better cope with the increased competition that will come with the full opening of the Chinese market.[86] However, only time will tell just how endemic the NPL problem truly is.[87]

E. Limited Chinese Credit Assessment Capabilities Leading to More NPLs

Related to the NPL issue is the reality that many of the large state-owned banks lack expertise or refinement in basic areas such as effective corporate governance techniques and credit evaluation.[88] Prior to the current banking reforms, most lending was oriented around fostering development goals and plans of the government rather than the dictates of the market.[89] Thus, China's banks have not been forced by market pressures to develop functional systems to evaluate credit, quality and adequacy of collateral, and other basic lending considerations.[90] Furthermore, the lack of reliable sources for even beginning to gather credit information on potential borrowers further hampers the development of efficient and profitable lending practices.[91] While progress has been made in evaluating credit, such skills are still in their infancy.[92]

For instance, as recently as April 2000, commentators pointed out that annual reports issued by some of the largest state-owned banks "rarely even mention selectivity in their lending or any indicator of improvements in their financial performance that might follow from increasing selectivity."[93] Instead of including information related to lending proficiency such as rate of return on equity or share of NPLs, the banks included information related to the absolute size of lending and deposits, signaling a continued fundamentally flawed conception of banking.[94] There are major institutional changes that must be made

---

86. Yan, *supra* note 84.

87. *See generally* James Kynge, *'Bold Action Needed' on China's Banks' Bad Loans*, FIN. TIMES (London), Oct. 1, 2002, at 14 (discussing speculation by some analysts who believe NPLs are actually increasing).

88. *See infra* notes 90-101 and accompanying text.

89. Cao, *supra* note 69, at 571.

90. *Id.* at 572.

91. *Id.*

92. Herrero & Santabarbara, *supra* note 12, at 23.

93. Lardy, *supra* note 80, at 33.

94. *Id.* at 33-34.

before balance sheets can be cleaned up and a true "commercial credit culture [can take] hold."[95]

Furthermore, with such a short history of practicing market-driven lending, the managerial talent needed to run a successful bank is also lacking.[96] Many of the banks do not possess essential oversight and corporate governance structures needed to operate efficiently.[97] For instance, when Frank Newman, a former U.S. Treasury Department Official and current executive with a Chinese bank visited China in 2005, he was surprised to find no financial reports on a "particular $25 billion institution."[98] Newman observed that, "In all my years of banking, I've never seen anything like it."[99] Without increased credit evaluation capabilities and managerial and technical know-how, Chinese banks are likely to continue to make bad loans, and the NPL problem may continue or even worsen in the indefinite future.[100]

F. Corruption

This lack of oversight, structure, and technical knowledge has also led to a great deal of corruption.[101] China Daily reported that "China's 2004 state audit report . . . uncovered billions of dollars of graft and misappropriation even as the state-run media questioned the government's resolve in fighting corruption."[102] In January 2005, two

95. *Id.* at 41.

96. Stakelbeck, *supra* note 30.

97. *Id.*

98. *Id.*

99. *Id.*

100. Bremner, *supra* note 3; *see also Billion-Dollar Gamble; Foreign Investment in China's Banks*, *supra* note 76 ("Nor, despite due diligence, do the foreigners really know how clean their partners' books are."); *see also* Matthias Bekeir, *Drowned in a Sea of Debt*, MCKINSEY & CO., Jan. 26, 2005, http://www.mckinsey.com/ideas/infocus/china/debtsea.asp.

> China's financial regulators may have stepped up their efforts to clean up the existing stock of non-performing loans, but the country's banking system has yet to deal with another source of instability—new bad debt. . . . While much progress has been made in China's biggest banks scheduled for public listing, less has been done to stem the flow of new bad debt in the 120-odd regional and local banks and nearly 30,000 credit co-operatives which hold up to 30 per cent of the country's banking assets.

Id.

101. Peerenboom, *supra* note 47, at 225.

102. *Former Bank Chief Tried on Corruption Charges*, CHINA DAILY, July 14, 2005,

senior officials from the Bank of China disappeared after allegedly embezzling up to $120 million dollars[103] and Liu Guangyi received a life sentence for stealing $13.4 million while serving as branch head of China Construction Bank in the southern province of Guangdon.[104] Liu Jinbao received a death sentence (which was eventually suspended) in August 2005 after his conviction for stealing $953,000 as chief of the Bank of China's Hong Kong arm.[105] Such ongoing fraud not only damages the balance sheets of the banks but also reveals continuing weaknesses in the structures of many of China's banks.[106]

G. *A Nation in Flux*

In just under thirty years, China has radically transformed its economic structures through a vast program of privatization, resulting in dramatic changes to the economic realities of the country.[107] What is not clear is how these vast economic changes will affect the cultural and political realities of a nation that is the only Communist member of the WTO.[108]

Investors, blinded by prospects of unparalleled opportunity, should not overlook the fact that China does not have laws protecting many of the rights and freedoms recognized by Western nations.[109] Many expect that as China pursues economic growth down the path of increasing economic openness and freedom, further personal and political rights and freedoms will blossom as well.[110] But it is not yet

---

http://www.chinadaily.com.cn/english/doc/2005-07/14/content_460222.htm.

103. *Millions Go Missing at China Bank*, BBC NEWS, Jan. 24, 2005, http://news.bbc.co.uk/1/hi/business/4201279.stm.

104. *China Bank Boss Jailed for Fraud*, BBC NEWS, Jan. 23, 2005, http://news.bbc.co.uk/1/hi/world/asia-pacific/4199295.stm.

105. *China Bank Ex-Exec Gets Suspended Death Sentence*, MUZI NEWS, Aug. 12, 2005, http://dailynews.muzi.com/ll/english/1375562.shtml; *Former Bank Chief Tried On Corruption Charges*, CHINA DAILY, July 14, 2005, http://www.chinadaily.com.cn/english/doc/2005-07/14/content_460222.htm.

106. *See supra* notes 88-105 and accompanying text

107. *See supra* notes 9-24 and accompanying text.

108. Halverson, *supra* note 28, at 320.

109. *See generally* Human Rights in China, http://www.hrichina.org/public/indexhttp://hrw.org/doc/?t=asia&c=china (last visited Jan. 23, 2006) (advocating for more awareness and response to human rights violations in China); Human Rights Watch: Asia, http://hrw.org/doc/?t=asia&c=china (last visited Jan. 23, 2006) (publicizing ongoing human rights violations in China); Yu et al., *supra* note 65, at 26.

110. Daniel T. Griswold, *Trading Tyranny for Freedom: How Open Markets Till the Soil*

clear whether this theory will become a reality.[111] While China may be applauded for its rapid economic liberalization, concurrent political and human rights reforms have been slow.[112] In the midst of the economic and legal changes that have accompanied China's WTO accession, "the [Chinese Communist Party] has endeavored to maintain rigid control over other spheres of Chinese society."[113]

While the "need to sustain economic growth will continue to put pressure on China's leaders to carry out reforms, even if this results in further erosion of the Party's power,"[114] it is unclear how far the government will be willing to go.[115] The freeing of the market place will make it increasingly difficult for the Chinese Communist Party ("CCP") to control individuals, but the Chinese leadership will likely remain vigilant in its protection of power, using repression when necessary.[116] And it would not be hard to imagine a scenario in which these contrasts lead to political and social unrest and instability which can, in turn, affect the banking and financial sector.[117] Furthermore, it remains to be seen how China deals with economic factors such as a growing presence and influence of foreign banks, which threaten or inhibit their autonomy, independence, or power.[118]

Analysis of this dynamic is made difficult by the fact that the CCP's continued power and importance is "more a matter of political reality than law."[119] For instance, Deng Xiaoping's power during the tail end of his life did not derive from any particular body of law but was simply political reality.[120] Moreover, there are no codified laws

---

for Democracy, http://www.freetrade.org/pubs/pas/tpa-026es.html (last visited Jan. 23, 2006).

111. *See infra* notes 113-31 and accompanying text.

112. Peerenboom, *supra* note 47, at 179.

113. Halverson, *supra* note 28, at 363.

114. Peerenboom, *supra* note 47, at 195.

115. *Id.* at 194-96.

116. Halverson, *supra* note 28, at 364.

117. *See* Pei Minxin, *China is Paying the Price of Rising Social Unrest*, FIN. TIMES (Asia Edition), Nov. 7, 2005 at 15; *see also As the Economy Booms, So Does Unrest*, ECONOMIST.COM, Dec. 13, 2005 (on file with North Carolina Banking Institute).

118. Chandrasekhar, *supra* note 75; *see also* William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China's Communist Politics and Capitalist Securities Market*, 27 BROOKLYN J. INT'L L. 477, 480 (2002) ("However, with the implementation of these Western capitalist market theories into the Chinese marketplace, the survival of the Party will be at stake.").

119. Peerenboom, *supra* note 47, at 201.

120. *Id.*

which govern the CCP's practice of the "nomenklatura system of appointments whereby the CCP appoints or approves the appointments of key personnel, usually CCP members, to positions of power within all of the major institutions, including the people's congresses, governments, courts and administrative agencies."[121]

The CCP has and will continue to retain final control while at the same time embracing the modernization that accompanies economic growth.[122] And because much of the CCP's conduits of power exist outside of any clear laws, it is impossible to know how they will affect and be affected by the vast economic changes.[123] Foreign investors must be aware of these realities and understand that they bring with them social and political uncertainties.[124]

Looking to the future it is conceivable that the government, under the direction of the CCP, might act in direct and indirect ways to prevent foreign banks from gaining too much control over China's domestic banking sector.[125] As discussed above, China does not intend

---

121. *Id.* at 201-02.

122. Halverson, *supra* note 28, at 321.

123. *See supra* notes 119-22 and accompanying text.

124. *See supra* notes 107-22 and accompanying text.

125. Bremner, *supra* note 3.

> Beijing still insists the government retain a majority stake in its Big Four state banks. (Post-IPO, China Construction Bank will be 62.5% owned by the state.) China has refused, despite pressure from Washington, to lift its twenty-five percent cap on total equity held by outsiders and twenty percent for any single investor. . . . Beijing, meanwhile, is still keeping as tight a grip on bank reform as it has on its broader economic opening—despite a weeklong visit by U.S. Treasury Secretary Snow and Securities and Exchange Commission Chairman Christopher Cox. In meetings with PBOC Governor Zhou Xiaochuan and China Securities Regulatory Commission Chairman Shang Fulin, Cox says he heard a lot of talk about gradual steps, not quick leaps. As Cox puts it: 'If you take nothing but half-steps to reach the wall, will you ever reach it?

Id.; see also Edmund L. Andrews, *U.S. Offers Details of Plan for Open Markets in China,* N.Y. TIMES, Oct. 16, 2005, at 4.

> That could backfire. Chinese leaders invariably bristle at pressure from American officials, and they could view the new American 'priorities' as an unwelcome intrusion. . . . But many of the Bush administration's proposals would encounter fierce political opposition from many quarters. China's state-owned banks and far-flung rural credit cooperatives have many defenders in the ruling [CCP], and they are certain to oppose well-financed competition from Western banks. Even without opposition from vested interests, many Chinese leaders are likely to fret over giving more freedom to foreign financial institutions

to raise the cap on foreign investment in Chinese banks.[126] And while the Chinese government may consider isolated exceptions to the limit, such as a possible approval of Citibank's recent majority acquisition of Guangdong Development Bank ("GDB"), such action does not necessarily signal an overall policy shift.[127] As many have pointed out, GDB is not in good financial shape and is not nearly large enough to pose a significant threat to the control exerted by the Big Four.[128]

Rather, such events should more likely be interpreted in light of an overall policy framework such as that articulated in recent comments by Shi Jiliang, a vice-chairman of the CBRC.[129] Jiliang hinted at potential actions by the government that would limit the ability of foreign banks to compete directly with domestic banks: "China may restrain the expansion of foreign banks to protect local lenders from 'excessive competition.'"[130] Such comments make clear that China may not be as willing to open the market as some might expect but, instead, intend to utilize foreign investment within the framework of national policy.[131]

IV. EQUITY IN CHINESE BANKS

Despite all of the problems discussed above, many banks still see China as a promising investment opportunity.[132] Such banks are convinced that "China has fundamental advantages over the U.S." in

---

to enter Chinese markets.

Id.

126. *See supra* notes 42-45 and accompanying text.

127. David Barboza & Andrew Ross Sorkin, *Citigroup Expected to Land China Deal*, N.Y. TIMES, Dec. 31, 2005, at C1; *see also* George Yang, *Japan Lender in Talks for BOC Equity*, THE STANDARD, Jan. 5, 2006 ("A Citigroup-led consortium has won an auction for about 85 percent of Guangzhou-based [GDB], which is widely regarded as a special case due to the mainland lender's large debt burden, and the imminent deal does not necessarily indicate a wider opening for foreign banks.").

128. Barboza & Sorkin, *supra* note 127.

129. Richard McGregor, *Beijing May Look to Protect Local Banks From Competition*, FIN. TIMES (London), Apr. 28, 2005, at 13.

130. *Id*; *see also* David Lague & Donald Greenlees, *China's Troubled Banks Lure Investors*, INT'L HERALD TRIB., Sept. 22, 2005, at 13, *available at* http://www.iht.com/articles/2005/09/21/business/bank.php ("But many doubt that China will ever relax the rules enough to permit foreigners to gain control of any major bank."); George Yang, *New Rules to Stabilize Financial Security*, THE STANDARD, Nov. 3, 2005.

131. McGregor, *supra* note 129.

132. *See infra* notes 133-51 and accompanying text.

terms of future earnings potential.[133] Commentators point to the breathtaking pace of growth of the Chinese economy and the enormous personal savings of the Chinese, a large source of underutilized capital.[134] Furthermore, the very largest U.S. banks such as Bank of America ("B of A") are or will eventually be limited in their domestic activities by the ten percent overall deposit cap still currently in place.[135]

However, foreign banks seeking to expand into China have been faced with the choice between establishing foreign bank branches or acquiring equity in domestic banks.[136] Thus far, such banks have overwhelmingly chosen to pursue equity acquisition.[137]

A. Recent Investment Activity

The first wave of foreign investment in Chinese banks occurred between 2001 and 2003.[138] During that period, seven major foreign corporations purchased equity in Chinese banks.[139] The largest acquisition during this period was Citigroup's investment in the Shanghai Pudong Development Bank ("SPDB") in January 2003.[140] Citigroup invested $72 million, acquiring a five percent ownership interest with an option to increase its investment in the future.[141]

In 2004, a new wave of investment began which dwarfed previous activity.[142] In August 2004, the British bank, Hong Kong and Shanghai Bank ("HSBC"), paid $1.75 billion to acquire a 19.9% share of the Bank of Communications.[143] In 2005, B of A invested $2.5 billion in China Construction Bank, receiving a nine percent stake in the

---

133. George Zhibin Gu, *A Clearer Path Ahead for China's Banks?*, ASIA TIMES, July 2, 2005, http://www.atimes.com/atimes/China/GG02Ad05.html.

134. *Id.*

135. BROOME & MARKHAM, *supra* note 46, at 739-40.

136. Liu, *supra* note 4, at 417-18.

137. *See infra* notes 138-51 and accompanying text.

138. Min Xu, *Feeding Frenzy for Overseas Banks*, ASIA TIMES ONLINE, Sept. 30, 2005, http://www.atimes.com/atimes/China_Business/GI30Cb03.html.

139. *Id.*

140. *Id.*; *Citigroup to Take 5 Percent of Shanghai Pudong Bank*, PEOPLE'S DAILY ONLINE, Jan. 3, 2003, http://english.people.com.cn/200301/03/eng20030103_109481.shtml.

141. *Citigroup to Buy More Shares of Pudong Bank*, TAIPEI TIMES, Aug. 26, 2005, http://www.taipeitimes.com/News/worldbiz/archives/2005/08/26/2003269247.

142. Xu, *supra* note 138.

143. *Id.*

bank,[144] which, at the time, was the single largest foreign investment in the Chinese banking sector.[145] B of A also retained the option to increase its equity stake in China Construction Bank to 19.9%.[146] In July 2005, Temasek acquired an estimated ten percent equity stake in China Construction Bank for $2.4 billion.[147] In August 2005, a consortium of investors led by Goldman Sachs paid $3.5 billion to acquire a ten percent stake in the Industrial and Commercial Bank of China, China's largest lender,[148] and Citigroup announced plans to increase its stake in SPDB to 19.9%.[149] Another investment consortium, led by Royal Bank of Scotland, paid $3.1 billion to acquire a ten percent equity interest in the Bank of China.[150] The growth in foreign investment was staggering, as foreign investors poured over $18 billion into the Chinese market during the years 2004 and 2005.[151]

B. Purchasing Equity in Established Chinese Banks is the Safest, Fastest, and Most Efficient Way to Enter China's Market in the Short Term

Purchasing equity in established banks is the safest, fastest and most efficient way for foreign banks to acquire a stake in the Chinese banking sector in the short term while avoiding or limiting some of the risk factors discussed above.[152] The following factors contribute to the current trend.[153]

---

144. *Id.*; *Bank of America Invests 2.5 Billion U.S. Dollars in CCB*, PEOPLE'S DAILY ONLINE, June 17, 2005, http://english.people.com.cn/200506/17/eng20050617_190816.html; *Bank of America Buys Stake in China Bank*, MSNBC, June 17, 2005, http://www.msnbc.msn.com/id/8253765/.

145. *Bank of America Buys Stake in China Bank*, *supra* note 144.

146. *Bank of America Invests 2.5 Billion U.S. Dollars in CCB*, *supra* note 144.

147. Chandrasekhar, *supra* note 75.

148. *Bank of America Invests 2.5 Billion U.S. Dollars in CCB*, *supra* note 144; Xu, *supra* note 138.

149. *Citigroup to Raise Pudong Bank Stake*, CRI ONLINE, Sept. 12, 2005, http://en.chinabroadcast.cn/855/2005/09/12/262@18793.htm.

150. Xu, *supra* note 138; *RBS Leads $3.1bn China Investment*, BBC NEWS, Aug. 18, 2005, http://news.bbc.co.uk/2/hi/business/4162170.stm.

151. Jonathan Anderson, *The Great Chinese Bank Sale*, FAR E. ECON. REV., Sept. 2005, http://www.feer.com/articles1/2005/0509/free/p007.html.

152. *See supra* notes 39-131 and accompanying text.

153. *See infra* notes 154-95 and accompanying text.

1. Immediate Rewards: Initial Public Offering

Acquiring a stake in established Chinese banks offers the potential for immediate return on profit if the bank is able to complete an initial public offering ("IPO").[154] In October 2005, China Construction Bank raised $8 billion in the first IPO of a major Chinese bank.[155] For large foreign investors who acquire equity prior to the IPO, there are potentially enormous returns to be had, at least on paper.[156] Analysts estimate that while B of A paid 1.15 times the book value when it acquired equity in China Construction Bank, China Construction Bank's stock will go public at 1.6 times its book value.[157] That would translate into a nearly $1 billion return on paper.[158] China's other major banks also plan IPO's, though details are not certain and immediate prospects are more tenuous.[159]

2. Immediate, On-the-Ground Learning and Faster Acceleration into the Market

By purchasing equity, foreign banks are able to gain experience learning and navigating the Chinese administrative and judicial systems from the inside of established banking operations.[160] In doing so, foreign banks tap into invaluable experience and knowledge already possessed by Chinese banks.[161] Working with established domestic banks also

---

154. Bremner, *supra* note 3; Tim Lee Master, *China Construction Bank Plans to Launch US$ 5B IPO Next Month*, THE STANDARD, Sept. 3, 2005.

155. David Barboza, *Chinese Milestone: A Major Bank Goes Public*, N.Y. TIMES, Oct. 28, 2005, at C4.

156. Bremner, *supra* note 3.

157. *Id.*

158. *Id.*

159. *Id.*

160. Lague & Greenlees, *supra* note 130 ("These investments also allow foreign banks to learn about the market and gain experience that can be applied to building their own brands in China.").

161. *Id.*; *see also* Timothy O'Keeffe, *China: An Evolving Market*, JP MORGAN CHASE, http://www.jpmorganchase.com/cm/ContentServer?cid=1102380207137&pagename=jpmorgan%2Fts%2FTS_Content%2FGeneral&c=TS_Content (last visited Jan. 23, 2006).

> By leveraging the local partner banks capability, treasurers will get the best of both worlds. They will have unparalleled access to the best local banking services, yet transact using a recognized standard of service administered by the foreign overlay bank. This is beneficial to both the domestic and foreign banks, with the treasurer reaping the benefits in

allows foreign banks to utilize the existing resources and structures of Chinese banks to gain faster access to the market.[162] For instance, by acquiring equity in China Construction Bank, B of A was able to gain access to a bank with a "huge footprint" and begin to establish a brand name recognized by millions of potential customers.[163] B of A would also be able to utilize the resources and experience of the third largest bank in China, a bank with 14,500 branches and $472 billion in assets (nearly thirteen percent of China's total deposits).[164]

A. CASE STUDY: CREDIT CARD MARKET

One particular example of this path of accelerated access and growth is China's emerging credit card market.[165] After acquiring equity in domestic banks, many foreign banks have proceeded to launch joint credit card ventures in order to gain market share and establish brand awareness.[166] By issuing credit cards in partnership with domestic banks, foreign banks such as Citibank hope to use "local bank's national distribution network for the jointly branded cards . . . [and] more importantly, avoid the restrictions still preventing foreigners from entering this business."[167] Furthermore, such partnerships can potentially accelerate the speed of entry as well as increase the scope of market access.[168] For instance, Citibank was able to take part in a

---

> enhanced service capabilities, as well as standardized practices, automated processes and increased investment options.

Id.

162. *See infra* notes 154-55 and accompanying text.

163. Bremner, *supra* note 3; *see also* Arthur Clennam, *Wish List Granted?: Multinational Treasurers Have Reason to Applaud A Recent Easing of Cash Management Restrictions in China*, CFO ASIA, Nov. 2004.

> Deutsche Bank's Yap also sees benefits in a partnership arrangement. "Because of the strong partnerships that we struck up with many of the Chinese banks,' he says, 'we get all the service levels in almost all places. You can open accounts with us, and yet this also gives you distribution across the country."

Id.

164. Gu, *supra* note 133.

165. *See infra* notes 166-83 and accompanying text.

166. Richard McGregor, *Younger Generation Warms to Credit Culture: Foreign Banks are Targeting Wealthier Clients with New Credit Card Services*, FIN. TIMES (London), Apr. 29, 2003, at 3.

167. *Id.*

168. *Citigroup's Deal for Credit Cards in China*, BBC NEWS, Jan. 3, 2003, http://news.bbc.co.uk/1/hi/business/2624459.stm.

nationwide credit card market just a year after its equity purchase, bypassing much of the time and effort it would require to take such a step independently.[169]

Current statistics, though somewhat inconsistent, depict a credit card market that is highly underdeveloped but possesses enormous opportunity for growth.[170] In 2003, only about 20 million of China's 1.3 billion consumers owned credit cards.[171] Other sources put the number as low as 1 million.[172] And as late as 2003, China still lacked a national bank clearing system with the capability to handle extensive transactions.[173] As a result, a majority of those who owned cards were only able to use them locally.[174] But some believe that the credit card market in China is in the beginning stages of a rapid expansion.[175] Market research done by the McKinsey & Company showed that the number of credit cards issued in China rose to 12 million in 2005.[176] In this context, foreign banks hope to utilize their expertise in the areas of retail banking and credit cards to help the credit card market mature and to establish a presence in the market as well.[177]

There have been many notable joint credit card ventures launched in the past two years.[178] In January 2004, HSBC and the Bank of Shanghai announced the launch of the Shanghai International Credit Card.[179] In February 2004, SPDB and Citibank issued Visa cards which were the first credit cards which "can be settled both in renminbi and U.S. dollars and which are supported by international cards

---

169. *Id.*

170. *See infra* notes 171-77 and accompanying text.

171. *Citigroup's Deal for Credit Cards in China*, *supra* note 168.

172. *Citigroup Buys into China's Cards Potential*, RETAIL BANKER INT'L, Jan. 14, 2003, at 2.

173. *Citigroup's Deal for Credit Cards in China*, *supra* note 168.

174. *Id.*

175. *Credit Card Fastest-Growing Retail Banking Business in China*, CHINA DAILY, Sept. 14, 2005, http://www.chinadaily.com.cn/english/doc/2005-09/14/content_477886.htm.

176. *Id.*

177. McGregor, *supra* note 166; Phillips *supra* note 78 ("Our research shows that credit cards, bank accounts and insurance products will be strongly in demand over the next 12 months, at least from the Chinese mass affluent market. Of this group...54.11 per cent get a new credit card").

178. *See infra* notes 179-83 and accompanying text.

179. *Banks Launch Credit Card*, CHINA DAILY, Jan. 2, 2004, http://www.chinadaily.com.cn/en/doc/2004-01/02/content_295406.htm.

management and technology expertise."[180] Using its partnership with SPDB to get a jump on the credit card market prior to the full easing of banking restrictions in 2006, Citibank aims to "spin off the credit card business into a separate unit as soon as regulations permit."[181] In the interim, Citibank "will effectively be running the business, using its own technology, and the cards will carry both banks' names."[182] The perceived value of entry into the credit card market is made clear by the head of Citibank's operations in China, who believes that while Citibank may not be able to compete with established banks in lending to private companies, the biggest opportunities involve exploration of consumer banking such as credit cards.[183]

3. Common Goals

By acquiring equity, foreign banks also tie their fortunes initially to established banks, many of which are still majority-owned by the government.[184] Given China's government's possible wariness towards any foreign bank's dominating influence, this route may perhaps make foreign bank's increased presence more palatable.[185]

---

180. Press Release, Citigroup Inc., Shanghai Pudong Development Bank and Citibank Launch Credit Cards in China (Feb. 04, 2004) http://www.citigroup.com/citigroup/press/2004/040204a.htm.

181. *Citigroup Buys into China's Cards Potential, supra* note 172.

182. *Id.*

183. McGregor, *supra* note 166.

184. *Rethinking Bank Regulation: Till Angels Govern*, MILKEN INST., http://www.milkeninstitute.org/events/events.taf?function=detail&ID=164&cat=Forums (last visited Jan. 23, 2006). While concrete data as to the percentage of the banking industry currently held by either Chinese government or local or provincial governments is inconsistent, James R. Barth and Gerard Caprio, Jr asserted in December 2005 that "ninety-eight percent of the banking assets are government owned." *Id.*; *see also* Luo Ping, China Banking Regulatory Comm'n, Challenges for China's Banking Sector and Policy Responses, at 2 (November, 2003), *available at* http://www.imf.org/external/np/apd/seminars/2003/newdelhi/ping.pdf (Pointing out that primary stockholders of the so-called "second tier" banks (joint-stock commercial banks) are local governments and state-owned or state-controlled enterprises); Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *Government Ownership of Banks* 37 (Harvard Inst. of Econ. Res., Discussion Paper No. 1890, Feb. 2000) (concluding that ninety-nine percent of the share of the assets of the top ten banks in China was owned or controlled by the government).

185. Bremner, *supra* note 3.

> Beijing's grand plan is to fix the main banks, inject foreign capital and expertise into the system, clean up the local bourses—and throw the financial markets virtually completely open to outside competition by December 6, 2006. . . . Neither China nor its banks have the managerial

Furthermore, such partnerships are welcomed by China because the Chinese banks are able to gain much needed experience and know-how from the foreign banks.[186]

For instance, in conjunction with B of A's investment in China Construction Bank, B of A plans to send a team of fifty managers into China to teach China Construction Bank managers basic banking tools and methodologies.[187] The B of A managers will train their Chinese counterparts in the basic skills of drafting loans in accordance with the particular risk levels faced as well as the accepted American practices of due diligence, which are still relatively new concepts in the Chinese banking sector.[188] B of A will also help China Construction Bank develop and modernize its information technology and corporate governance practices.[189]

The joint development of the emerging credit card market also dovetails nicely with other central government objectives.[190] China has recognized its need to increase consumer spending, hoping that such spending can begin to take the place of the government's fiscal stimulus, which to this point, has been the primary driving force of China's economic growth.[191] During a recent visit to China, Treasury Secretary John W. Snow echoed this sentiment, encouraging the

---

> resources they need to build a better banking system. For that they are depending on investors like [B of A].

Id.; *see also Billion-Dollar Gamble*, *supra* note 76 ("It may also be that the Chinese banks will simply want to learn the tricks of the trade from their western partners before freezing them out."); David Lague, *Betting High on Risky China*, INT'L HERALD TRIB., Oct. 21, 2005, at 12 ("The plan is that this new capital will put the banks on a sounder financial footing while foreign investors assist their Chinese partners to try and put an end to entrenched mismanagement, corruption and poor lending practices.").

186. Master, *supra* note 154; *see also China Industry: CCB Selling Promise of Chinese Banks*, ECONOMIST: EIU VIEWSWIRE, Oct. 5, 2005, http://www.viewswire.com/index.asp?layout=display_article&doc_id=919467077 ("Moreover, if their new foreign partners can help China's banks to better identify stronger, less risky loan opportunities, the banks in turn will find themselves contributing to sustained and sustainable economic growth."); Louise Do Rosario, *Preparing for the Competition—China's Barriers to Foreign Banks Will Soon Be Coming Down but Their Expertise Will Also Be Useful to Local Institutions*, BANKER, Mar. 1, 2004 ("The CBRC has recently issued well-publicized statements praising foreign banks that have acquired stakes in Chinese banks for their 'significant contribution' to these entities.").

187. Bremner, *supra* note 3.

188. *Id.*

189. *Id.*

190. *See infra* notes 191-93 and accompanying text.

191. McGregor, *supra* note 166.

Chinese towards increased spending and use of credit as well as increasing sophistication and modernization in their financial sector.[192] Many speculate that increased use of credit cards and familiarity with a credit culture will, in turn, lead to more consumer spending and vice versa.[193]

Recent surveys have also indicated that the general public in China also believes that foreign partnerships will improve the overall quality of banking services.[194] Such partnerships, it is believed, will lead to less corruption and improved service.[195]

V. CONCLUSION

To date, foreign investment in the banking sector of China has consisted mainly of equity acquisition in Chinese banks.[196] This route into China's banking market addresses some of the major uncertainties and concerns associated with the Chinese market.[197] First, equity acquisition offers the possibility of great initial return on investment in the event that the domestic bank is able to muster an IPO.[198] Second, investors are able to gain access to the market using the resources and the existing "footprint" of these established banks.[199] Such access also allows banks to get a foot in the door of the emerging credit market in China.[200] Eventually, foreign banks will have to establish independent operations if they wish to grow beyond the cap imposed on overall foreign ownership of domestic banks, but equity ownership allows banks to begin the learning process immediately.[201] Third, working with established banks creates a situation in which the goals and objectives of the investors coincide with those of China's government,

192. Edmund L. Andrews, *Snow Urges Consumerism on China Trip*, N. Y. TIMES, Oct. 14, 2005, at C1.

193. McGregor, *supra* note 166.

194. Phillips, *supra* note 78.

195. *Id.*

196. *See supra* notes 138-51 and accompanying text.

197. *See supra* notes 154-95 and accompanying text.

198. *See supra* notes 154-59 and accompanying text.

199. *See supra* notes 160-64 and accompanying text.

200. *See supra* notes 165-83 and accompanying text.

201. *See supra* notes 160-83 and accompanying text.

thereby decreasing any tension or uncertainties that might result from a growing foreign presence in the banking market.[202]

JACK E. JIRAK

202. *See supra* notes 184-95 and accompanying text.